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Seeking The Road To El Dorado

Our Ms. Goody Two-Shoes — California Joan — is back to warn about investing in clients' companies

By ELLEN R. PECK

Editor's Note: This is part one of a two-part article. Join us next month when Meryl Terpitude and California Joan map out the ethical bumps on the road to El Dorado, acquiring stock in client companies.

Meryl Terpitude admired the golden aura of El Dorado in the distance. As he entered the city, his chauffeur turned onto a broad golden palm-lined boulevard in the most fashionable neighborhood. Meryl sighed with contentment as he surveyed the well-manicured grounds, after passing through the gates and glided up to a huge mansion with his wife and children waving at him from the front door.

Meryl awoke with a start, his pleasurable dreams of El Dorado still lingering with him. While shaving, Meryl looked himself straight in the eyes and vowed to accept his clients' offers of taking stock in their startup companies. "It's the road to El Dorado!" he sighed. "I just hope that 'goody two-shoes' California Joan, with her unhealthy fixation on ethics, doesn't talk the other partners out of making money investing in our clients."

Later that morning, Meryl approached Marvin Manage, the Firm's management committee chair, about a change in the Firm's policy about business transactions with clients. "Marv, most big firms in California and a great number of boutique smaller firms take equity positions in their client start-up companies," Meryl pitched. "In fact, some of the big firms will not even represent start-up companies unless the client is prepared to give the firm an equity position plus its legal fees. We're missing out on terrific opportunities enjoyed by lawyers all over the state!"

"Meryl, I still don't understand why corporate clients would want their lawyers having a piece of them

. . . . Seems to me that a client would worry about the lawyers' self-interest and their loyalties," Marv said.

"Marv, it's just the opposite," said Meryl. "Clients perceive that lawyers' equity stake in the client provides additional loyalty incentives such as providing higher levels of business advice, in addition to the routine legal services or increasing the quality and quantity of the investor contacts made through the lawyer.

"For other clients, giving stock in lieu of paying attorneys' fees is a means of assuring access to legal services while ensuring that the company reserves precious cash for its start-up.

Still other clients perceive that transaction costs for lawyer-found investors will be lower because the lawyer is providing dual legal and business services. [Gwyneth E. McAlpine, "Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?" (1999) 47 UCLA L. Rev. 549, 569-575.]

"We have two current clients with really hot products that keep asking the Firm to invest in their companies — these are opportunities that are too good to pass up — why, they're the road to El Dorado!"

"All right, Meryl, maybe the Firm's management committee should revisit the Firm's prohibition against taking equity positions in our clients. I'll put it on the agenda for tomorrow's meeting," Marv promised. Meryl pitched all of the other members of the management committee, except California Joan, before the meeting.

The next day, at the Firm's management meeting, Meryl presented the proposal for changing the firm's policy and permitting taking an equity position in client companies. Most of the members of the committee, having heard of the earnings that other firms garnered from their equity positions with clients, wanted to get on the road to El Dorado with Meryl. However, they were concerned about the ethical proprieties and the risks and turned anxiously toward California Joan, the Firm's ethics and risk management expert for answers.

California Joan cleared her throat and stated, "There is no California standard which expressly prohibits the Firm from taking equity positions in clients. But," Cali went on, "there are three general danger zones where the potential for ethical violations or related risk is high: (1) in the acquisition of equity positions, compliance with California professional standards; (2) analysis of our liability insurance policy and compliance with the guidelines of our insurers, if any, and (3) post-acquisition potential conflicts of interest or other challenges to our fiduciary duties."

Legal malpractice insurance

"Cali, let's take the legal malpractice issue first. If we lost legal malpractice coverage because we take a flyer on a client's valueless stock, that would be a disaster!"shuddered Polly Policy, the Firm's insurance expert.

"Well, Polly, the insurance company environment is changing on these issues. Some legal malpractice policies specifically exclude coverage for any client claims against a lawyer where the lawyer has had a business transaction with that client or has invested in the client. Two years ago, our policy had that exclusion. Therefore, lawyers or firms should check their errors and omissions policies carefully before proceeding with equity investing in clients."

"Cali, does our present legal malpractice policy also have a complete exclusion?"queried a nervous Polly.

"No. Our current policy gives us legal malpractice coverage provided that our equity positions or business activities with clients are limited. Here's what it says:

"The Company will not pay any Loss or any Defense Expenses resulting from Claims against Insureds: . . . based on, arising out of or resulting from any Wrongful Act by any Insured in connection with any entity other than an Insured where:

(1) such entity is a publicly traded company and 5 percent or more of its issued and outstanding voting stock is owned or controlled directly or indirectly by one or more Insureds, or was so owned or controlled at any time such entity was a client of the Firm, or

(2) such entity is not a publicly traded company and 25 percent or more of its issued and outstanding voting stock is owned or controlled directly or indirectly by one or more Insureds, or was so owned or controlled at any time such entity was a client of the Firm, or

(3) such entity is controlled, operated or managed directly or indirectly by one or more Insureds, or was so controlled, operated or managed at any time such business or entity was a client of the Firm.

"By the way, the exclusion does not apply if the Firm's ownership, control, operation or management of such entity was exclusively in a fiduciary capacity incident to the practice of law by the Firm," answered Cali. "Many insurers have similar policies. Some policies have no exclusions but the insurance companies recommend that their policy holders follow certain guidelines.

"Therefore, I strongly recommend that if we make equity investments in our clients, we should comply with the limits of whatever policy we have and we should examine the policy on a yearly basis, making sure that our investments stay within any future limitations or exclusions," suggested Cali.

The committee then voted to appoint Cali and Polly to review their legal malpractice insurance policy closely and make recommendations concerning the limits of any Firm equity investment in clients or to recommend whether the firm should seek a new policy of insurance without an exclusion.

The committee also asked them to review the activities of all lawyers within the firm to ensure that their activities did not involve them in the operation or management of any business or entity which was or had been a client of the Firm.

The committee's written policy prohibiting any Firm lawyer from controlling any business or entity which was a Firm client was adopted by the Partners.

The bottom line

Meryl Terpitude decided to bite the bullet and asked, "So what's the bottom line here, Cali? Do you recommend that we take equity positions in clients or not?"

Cali smiled at him and replied, "Meryl, I have two answers for you. The safest risk management position is to continue to serve our clients competently and ethically without taking any equity positions in our clients.

"However, the safest risk management decision is not always the best business decision, especially in a climate where our business clients expect and desire the Firm to invest in them. My recommendation, therefore, is that if the Firm makes a business decision to invest in the clients it serves, the Firm should first develop strict written guidelines for investment in clients to manage the ethical and legal malpractice risk.

"Moreover, once adopted, the Firm should follow those guidelines to the letter in every transaction. Finally, the Firm should monitor the written policies regularly and amend them as we discover changing situations or new risks."

Meryl, in disbelief that Cali might further his dreams of El Dorado, was speechless for one of the few times in his life. The Committee adopted Cali's recommendation.

Ethical risks in acquiring stock

Marv then asked, "Cali, what are some of the risks in acquiring equity positions?"

Cali answered, "Marv, I have good news and bad news. The good news is that three non-California ethics committees have issued opinions on the subject of taking stock in a client's company in lieu of partial or full payment of attorneys fees. [American Bar Association Formal Ethics Opinion 00-418, Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Opinion 2000-3, District of Columbia Bar Association Legal Ethics Committee Opinion No. 300.] All three have opined that taking stock in these circumstances is permissible, provided that a lawyer comply with professional conduct rules in three basic areas:

Rules regulating business transactions with clients (ABA Model Rule 1.8(a), N.Y. DR 5-104(A) [substantially similar to rule 3-300, California Rules of Professional Conduct].)

Rules regulating amount of fees (reasonable fees — ABA Model Rule 1.5(a); excessive fees — N.Y. DR 2-106(A); in California, a lawyer cannot enter into an agreement, charge or collect an unconscionable fee — rule 4-200(A).)

Rules regulating conflicts of interest — having an interest in the subject matter of the transaction or representation or having situations challenging a lawyer's independence of professional judgment (ABA Model Rule 1.7(b), (c); N.Y. DR 5-101(A); [in California, a lawyer must disclose in writing a financial or business interest in the subject matter of the transaction — rule 3- 310(B)(4)].)

"The bad news is that no California ethics opinion has been generated on this subject at this time. Therefore, in acquiring stock in our clients, each acquisition should be examined carefully to determine that it complies with California's professional standards using this three-point test articulated in out-of-state ethics opinions," Cali finished.

Purchasing client stock

Meryl, finding his voice, asked, "Cali, can we talk about compliance with rule 3-300, Rules of Professional Conduct? The Firm's transactional department represents XYZ Corp., a publicly traded company. Lana Litigator, in the Litigation Department, bought 1000 shares of XYZ Corp. out of billions on the open market. Should the Firm have complied with rule 3-300?"

"I do not think so, Meryl," answered Cali. "ABA Opinion No. 00-418 holds the ABA counterpart rule does not apply when a lawyer acquires stock in an open market purchase or in other circumstances not involving direct intervention by the client. Although there is no California case or opinion on point, I believe that the reasoning of this opinion applies to rule 3-300.

"Also, in order for rule 3-300 to apply, there has to be a business transaction with the client (not present when purchasing publicly traded stock on the open market) or the acquisition has to be 'adverse' to the client. The California Supreme Court has held that whenever the lawyer has acquired the ability to summarily extinguish the client's interest in the client's property without judicial intervention it is 'adverse' and the lawyer must comply with rule 3-300." [Hawk v. State Bar (1988) 45 Cal.3d 589.]

"In purchasing stock on the open market, a lawyer does not acquire the ability to summarily extinguish the client's interest in the stock because there are client opportunities for judicial and administrative intervention. Therefore, I do not think that rule 3-300 applies.

"Of course, there are other issues — for example, federal regulations against insider trading must be complied with. Also, there may be other applicable conflict rules which arise which I will describe later."

Accepting stock for fees

Marv Manage asked, "Our client ABC Corp. owes us a substantial past due bill for defending it in litigation for which there was no insurance coverage. ABC's President has indicated that the company has some cash flow problems. She has asked whether we would take shares in the company at a value equal to the amount of the past due attorneys' fees owed. Do we have to comply with rule 3-300 if we say yes?"

"Marv, I think rule 3-300 applies, since its official discussion states: 'Rule 3-300 is intended to apply where the member wishes to obtain an interest in client's property in order to secure the amount of the member's past due or future fees.'"

"Why should rule 3-300 apply to this situation, Cali?" argued Meryl. "If we are taking stock that is exactly equal in value to the amount of past due fees owed, isn't that like taking cash or a check (which do not require compliance with rule 3-300)?"

"Well, Meryl, unlike cash or checks which have pretty much the same value in time, the value of shares of stock can fluctuate, sometimes even sharply from day to day. Therefore, while the shares of stock may be worth the exact amount of fees on one day, the next day, week or month, the value may increase dramatically. By accepting the shares of stock, we would acquire the ability to summarily extinguish ABC's ownership of the stock (and thereby potential profits) by selling the stock to a third party, without any judicial intervention. Therefore, I am concerned that taking stock in lieu of cash for the satisfaction of past due attorneys' fees may well be considered an 'adverse' pecuniary acquisition, even if we were to ignore the language of the official discussion.

"In any transaction in which we acquire stock in exchange for future or past services, we should assume, for risk management purposes, that rule 3-300 applies and go through the steps of compliance. After awhile, our compliance steps will become routine," Cali urged.

The Committee determined, as a matter of policy, to comply with rule 3-300 in all transactions wherein stock of a client was acquired in connection with fees for attorney services.

Acceptance of stock for compensation does not invoke the presumption of undue influence

Ernie Estate Planner got alarmed. "Cali, any transaction between a trustee and a beneficiary by which the trustee obtains an advantage from the beneficiary, is presumed to violate the trustee's fiduciary duties as set forth in Probate Code §16004(c). I understand that §16004(c) has been expressly applied to the attorney-client relationship, although solely for shifting the burden of proof. [Ramirez v. Sturdevant (1994) 21 Cal. App. 4th 904, 916, 26 Cal. Rptr. 2d 554, 560.] If we accept stock in lieu of attorneys' fees, are we presumed to be in violation of our fiduciary duties?"

"Actually, no, Ernie," Cali answered, trying to quell the rush of panic spreading throughout the committee. "The last sentence of §16004 specifically exempts from the presumption any agreement relating to the 'hiring or compensation' of the trustee/attorney. This exemption has been held to apply even where there is a pre-existing attorney-client relationship. [Walton v. Broglio (1975) 52 Cal.App.3d 400, 404, 125Cal.Rptr.123.] Therefore, as long as we acquire the stock as part of our hiring or compensation, the presumption of undue influence will not apply. Even though the presumption does not apply, we still have to comply with rule 3-300."

Five steps to comply

Marv then asked Cali what steps were required to comply with rule 3-300. Cali said compliance with rule 3-300 involves five steps:

Ensuring that the acquisition is fair and reasonable to the client.

Documenting the terms of the transaction in writing, in terms which can be reasonably understood by the client.

Giving the client a written advisement of the opportunity to seek independent counsel of the client's choice.

Affording the client an opportunity to seek the advice of independent counsel on the transaction.

Obtaining the client's written consent to the terms of the transaction after compliance with the first four steps.

Marv then adjourned the meeting asking Cali to be prepared to present further detail on concepts of "fairness and reasonableness" in stock transactions and compliance with the other four steps at the next meeting. As they left the meeting, Cali smiled at Meryl, saying "Meryl, we're on the road to your El Dorado."

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Test — Legal Ethics
1 Hour MCLE Credit

This test will earn 1 hour of MCLE credit in Legal Ethics.

1. True/False. California's professional standards expressly prohibit lawyers from taking equity positions in client companies or organizations.

2. True/False. Acquisition of stock in a client company in lieu of fees for legal services creates a presumption of undue influence.

3. True/False. Generally, business clients are concerned that awarding their lawyers stock in lieu of attorneys' fees will heighten their lawyer's focus on their own self-interest and create divided loyalties.

4. True/False. Some policies for legal malpractice insurance exclude coverage for legal malpractice claims in which the lawyer or law firm acquired an equity position in a client company.

5. True/False. Some policies of legal malpractice insurance exclude coverage for legal malpractice claims in which the lawyer or law firm acquired an equity position in a client company which was outside the terms specified in the policy.

6. True/False. California's ethics committee has opined that taking an equity position in a client company creates an inherent conflict of interest and is therefore prohibited.

7. True/False. In taking stock in a client company in lieu of attorneys' fees, a lawyer should ensure that the transaction does not result in the collection of an unconscionable fee.

8. True/False. Lawyer's firm represents ABC Corp. Lawyer purchases 1,000 shares of ABC's publicly traded stock on the New York Stock Exchange. This purchase does not violate any professional obligations the attorney may have.

9. True/False. In order for rule 3-300 to apply to a financial transaction with a client, the lawyer's acquisition must be "adverse" to the client.

10. True/False. "Adverse" to the client means that the lawyer has acquired the ability to summarily extinguish the client's interest in the client's property.

11. True/False. A lawyer attempting to secure the payment of past due fees through the acquisition of stock in the client company does not have to comply with rule 3-300.

12. True/False. A lawyer who intentionally entered into an agreement for an unreasonable fee, which is not unconscionable, is subject to discipline in California.

13. True/False. The terms of a lawyer's acquisition of stock in a client's company in lieu of fees must be fair and reasonable to the client.

14. True/False. A lawyer's acquisition of stock in a client's company in lieu of fees does not have to be documented, since the face of the shares show the amount of the stock and the client's direction to issue the shares demonstrate the client's consent.

15. True/False. A lawyer who is acquiring stock in a client's company in lieu of fees must advise the client to seek the advice of an independent lawyer.

16. True/False. If a client does not have the advice of independent counsel about a lawyer's acquisition of stock in a client's company in lieu of fees, the lawyer is subject to discipline.

17. True/False. A client must consent, in writing, to a lawyer's acquisition of stock in the client's company in lieu of fees in order for the lawyer to comply with rule 3-300.

18. True/False. Some clients perceive giving stock in their companies to lawyers in lieu of legal fees as a means of gaining access to legal services.

19. True/False. Giving lawyers stock in a client company in lieu of fees is a benefit to the client because it enables the company to reserve operating cash.

20. True/False. Ethics opinions of other jurisdictions cannot be consulted for guidance by California attorneys.

Certification

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